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In the Supreme Court of the United States

OCTOBER TERM, 1934

No. 125

JOHN P. MCLAUGHLIN, COLLECTOR OF INTERNAL REVENUE for the First District of California, petitioner

v.

PACIFIC LUMBER COMPANY, A CORPORATION

ON A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE NINTH CIRCUIT

BRIEF FOR THE PETITIONER

OPINIONS BELOW

No written opinion was filed by the District Court. The opinion of the Circuit Court of Appeals (R. 54–60) is reported in 66 F. (2d) 895.

JURISDICTION

The judgment of the Circuit Court of Appeals was entered September 6, 1933 (R. 60). A petition for rehearing was filed October 4, 1933, and was denied February 23, 1934 (R. 60–61). Subse-

quently a motion for leave to file a second petition for rehearing and for reconsideration was filed May 1, 1934 (R. 61–62). This motion was denied May 7, 1934 (R. 65–66). On May 15, 1934, Mr. Justice Sutherland entered an order granting an extension of time for filing a petition for a writ of certiorari for a period of thirty days from May 23, 1934 (R. 67). The petition for a writ of certiorari was filed June 22, 1934, and granted October 8, 1934. The jurisdiction of this Court is invoked under Section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

QUESTION PRESENTED

Whether the respondent was entitled to deduct stock losses and bad debts claimed to result upon the liquidation of its subsidiary where the respondent, through the medium of consolidated returns, had been allowed to deduct from its income losses of its subsidiary exceeding the amount of its investment in the subsidiary represented by the cost of its stock of the subsidiary and advances to it.

STATUTES AND REGULATIONS INVOLVED

The statutes and regulations involved are set forth in the Appendix, *infra,* pp. 24–25.

STATEMENT

The respondent instituted this action in the District Court for the Northern District of California for the recovery of an alleged overpayment of income taxes for the calendar year 1923 in the amount of $143,122.23. The overpayment was alleged to

result from the failure to allow as deductions for the taxable year a loss sustained upon the liquidation of A. F. Thane & Company and bad debts owing from the said company. The case was tried without a jury upon an agreed statement of facts which disclosed the following (R. 32–40):

Prior to 1920 the respondent, a Maine corporation, having its principal office in California, owned 540 of 600 shares outstanding of A. F. Thane & Company stock which it had acquired at a cost of $31,500 (R. 33). In 1920 the stock was increased to 5,000 shares and the respondent subscribed for 3,960 additional shares, for which it paid $100 each. In 1921 the respondent purchased the remaining 500 shares for $52,125. The total sum paid for the 5,000 shares which it owned at the end of 1921 was $479,625 (R. 33–34). During the period between March 17, 1921, and the close of December 1923 the respondent advanced cash to, paid accounts for, and assumed indebtedness of A. F. Thane & Company in the total amount of $1,234,157.09, for which it received partial repayment prior to the close of December 1923 in the amount of $260,461.88 (R. 34). At the close of 1923 A. F. Thane & Company was duly dissolved and was liquidated by transfer of all of its remaining assets to the respondent and by ceasing to do business. The assets thus transferred were carried on A. F. Thane & Company's books at a total value of $20,560.72 and were taken over by the respondent at this value (R. 34–35). The net amount due to the respondent

as the result of all the debt transactions was $953,134.49, which the respondent charged off its books as a debt ascertained to be worthless during the year 1923 (R. 35).

During the years 1920 to 1923, inclusive, the respondent was affiliated with A. F. Thane & Company and the Pacific Lumber Company, an Illinois corporation (R. 35–36). Separate tax returns were filed by each of these companies and also consolidated returns were filed showing the operations of the three companies. Taxes were paid upon the net income shown in the consolidated returns. The separate and consolidated returns showed the following net incomes and losses of the affiliated corporations (R. 36–37):

	1920	1921	1922	1923
Pacific Lumber Company of Maine, Respondent	$2,262,959.39	$379,624.88	$1,266,450.51	$1,379,494.78
A. F. Thane & Company	[1] 443,821.95	[1] 548,166.82	[1] 344,791.49	[1] 229,942.15
Pacific Lumber Company of Illinois	[1] 23,052.35	18,314.97	31,198.03	8,809.83
Consolidated	1,796,085.09	[1] 150,226.97	952,857.05	1,158,362.46

[1] Net loss.

The consolidated net loss of $150,226.97 for 1921 was allowed as a deduction from the consolidated net income for 1922, resulting in a consolidated net income for the latter year of $802,630.08, upon which the tax was paid.

Upon the consolidated income of $1,158,362.46 for the year 1923 the respondent paid to the petitioner the sum of $144,795.31 as the total income tax for that year. Thereafter upon examination and audit the respondent's corrected net income for the year 1923 was found to be $1,144,977.80 and the

amount of $143,122.23 was found to be the total amount of income tax due. The respondent received a refund of $1,673.08, with interest, from the petitioner on account of the difference between the amount of tax shown on the return and the amount calculated upon the corrected net income (R. 37–38). On March 14, 1928, the respondent filed a claim for refund of the total amount of $143,122.23, together with interest thereon. The claim was rejected by the Commissioner on June 14, 1928 (R. 38).

The District Court entered judgment for the respondent in the principal amount of $143,122.23 with interest thereon to January 13, 1932, in the sum of $64,977.53 and interest on these amounts from January 13, 1932, until paid (R. 29–31). The Circuit Court of Appeals affirmed the judgment of the District Court (R. 54–60).

SPECIFICATION OF ERRORS TO BE URGED

The Circuit Court of Appeals erred:

1. In holding that the allowances claimed by the respondent as the result of the liquidation of A. F. Thane & Company did not constitute a double deduction.

2. In holding that the petitioner had failed to establish any specific instance of a double deduction.

3. In failing and refusing to hold that the stock losses and bad debts claimed as deductions by the

respondent for the year 1923 as a result of the liquidation of A. F. Thane & Company in the amounts of $479,625 and $953,134.49, respectively, totalling $1,432,759.49, must be offset by the losses sustained by A. F. Thane & Company during the years 1920 to 1923, inclusive, in the aggregate amount of $1,508,399.58, of which the respondent received the benefit as deductions in consolidated returns filed for such years.

4. In affirming the judgment of the District Court.

ARGUMENT

I

PURPOSE OF CONSOLIDATED RETURNS

The purpose of requiring a consolidated return by affiliated corporations was to provide for the levying of the tax on the true net income of a single business enterprise, even though the business was operated through more than one corporation. The above principle was laid down in Treasury Regulations 62, Article 631, and was approved by this Court in *Handy & Harman* v. *Burnet,* 284 U. S. 136. In *Burnet* v. *Aluminum Goods Co.,* 287 U. S. 544, this Court said (p. 547):

> Primarily, the consolidated return was to preclude reduction of the total tax payable by the business, viewed as a unit, by redistribution of income or capital among the component corporations by means of intercompany transactions.

The Court pointed out that the underlying purpose of the statute and regulations governing the consolidated returns was (p. 550)—

> to prevent, through the exercise of a common power of control, any intercompany manipulation which would distort invested capital or the true income of the unitary business carried on by the affiliated corporations. * * *

The Court laid down the groundwork for its decision in the *Ilfeld* case in ruling that equitable principles of accounting should be applied in calculating the true income of the business unit, thereby precluding (p. 550)—

> any intercompany manipulation which would distort invested capital or the true income of the unitary business carried on by the affiliated corporations.

In concluding its opinion, the Court laid down the general rule that the pertinent regulations required (p. 551)—

> the elimination of any losses resulting from intercompany transactions the inclusion of which would defeat the purpose of consolidated returns to tax the true income of the single business of affiliated corporations, calculated by correct accounting methods. * * *

The consolidated group, as such, is not a taxpayer but a tax-computing unit, and the corporations which are members of the affiliated group lose their

separate identity while so affiliated only for the purpose of computation of the tax upon one income, which is the true net income of such combined corporations. (*Swift & Co.* v. *United States*, 38 F. (2d) 365 (C. Cls.), ~~affirmed, 282 U. S. 468~~. The consolidated return provisions view the business as a unit, in practical effect a single enterprise conducting the business through several different branches. "The purpose of the Congress was to secure substantial equality among stockholders who ultimately bear the burden of taxation and to prevent evasion through the manipulation of intercompany transactions." *Atlantic City Co.* v. *Commissioner*, 288 U. S. 152, 154. If the respondent had in fact conducted its business through unincorporated branches, the double deduction here claimed would be impossible.

The fact that the purchase of the stock by the parent represented a capital investment, while the losses of the subsidiary in years prior to liquidation were operating losses, can not serve to permit the parent to recover more than its actual investment. The operating losses of prior years were not the respondent's but were those of the subsidiary. As they occurred they served to impair the capital value of the subsidiary equally with the amount of the advances made by the respondent for use in the subsidiary's operations. These losses were reflected in the diminishing value of the parent's stock investment in the subsidiary and the obligations represented by the advances. Mere

nomenclature can not suffice to give a double allowance.

The construction of tax statutes and the application of those statutes to individual cases is a problem for practical minds wherein technical refinements should be disregarded. One must have regard "to the very truth of the matter, to substance and not to form". *Eisner* v. *Macomber,* 252 U. S. 189, 211.

In the case of *Tyler* v. *United States,* 281 U. S. 497, Mr. Justice Sutherland said (p. 503):

> The power of taxation is a fundamental and imperious necessity of all government, not to be restricted by mere legal fictions. * * * Taxation, as it many times has been said, is eminently practical, * * *

See also *Reinecke* v. *Smith,* 289 U. S. 172, at p. 177.

Other cases referring to the purpose of consolidated returns are collected in the opinion of the Circuit Court of Appeals for the Tenth Circuit in the case of *Golden Cycle Corp.* v. *Commissioner,* 51 F. (2d) 927, and discussed at pages 931–932:

> There is no obscurity as to the purpose of these statutes and regulations. Their purpose was to prevent corporations from avoiding the payment of their share of the war taxes by the device of affiliation. When the 1918 act was before Congress, the chairman of the Finance Committee recommended its passage "because the principle of taxing as a business unit what in reality is a business unit is sound and equitable."

The ranking minority member of the Committee joined in the recommendation, saying, "It is impossible to determine the true profits of such a combined enterprise except by treating the enterprise as a unit and disregarding the incidental placing of different branches in legally separate corporations." The statutes and the regulations have been many times construed.

II

ALLOWANCE OF THE LOSS WOULD AMOUNT TO DOUBLE DEDUCTION

Where, through the medium of consolidated returns for prior years, the parent corporation has been enabled to deduct operating losses of the subsidiary aggregating more than the parent's actual stock investment and advances, a further allowance on liquidation of the subsidiary would be the practical equivalent of a double deduction, which should not be allowed. In support of the above argument counsel for the petitioner rely chiefly upon the principles enunciated by this Court in *Burnet* v. *Aluminum Goods Co., supra,* and applied in the case of *Ilfeld Co.* v. *Hernandez,* 292 U. S. 62, the facts of the *Ilfeld* case being identical with those of the case at bar.

In the decision in the *Ilfeld* case, *supra,* this Court concluded that the principle, laid down in the *Aluminum Goods Co.* case, should be applied for the reason that the deductions claimed would have the effect of defeating the purpose of consolidated

returns to tax the true income of the single business of affiliated corporations. One of the reasons given for the disallowance was that since the taxpayer had been enabled, through the medium of consolidated returns in the years prior to liquidation, to deduct operating losses of the subsidiary aggregating more than the parent's actual stock investment and advances, a further allowance on liquidation of the subsidiary would be the practical equivalent of a double deduction, which could not be allowed in the absence of a statutory provision granting the right. Since the decision of this Court in the *Ilfeld* case is deemed controlling in the present case, the factual similarity of the two cases will be pointed out.

A footnote in this Court's opinion in the *Ilfeld* case shows that the taxpayer had deducted prior to 1929 operating losses of its subsidiaries in the aggregate amount of $190,431.66 and claimed an investment loss in the subsidiaries for 1929, the year of liquidation, in the amount of $130,792.11, making a total of losses claimed of $321,223.77, while its actual investment (stock plus advances) amounted to but $168,812.49. The aggregate operating losses of the subsidiaries theretofore allowed ($190,431.66) exceeded the loss claimed on liquidation ($130,792.11) by $59,639.55. In the instant case the agreed statement of facts discloses (R. 36–37) that through the consolidated returns of the years 1920 to 1923, inclusive, the respondent deducted operating losses of A. F. Thane & Company,

aggregating not less than $1,508,399.58. The investment loss claimed by the respondent for the year 1923 upon the stock and unrepaid advances amounted to $1,432,759.49, making a total of losses claimed of $2,941,159.07, while the respondent's actual investment (stock plus advances) amounted to $1,713,782.09, subject to credits of $281,022.60; leaving $1,432,759.49. The aggregate operating losses of the subsidiary theretofore allowed ($1,508,399.58) exceeded the loss claimed on liquidation ($1,432,759.49) by $75,640.09. These facts make it clear that the allowance of any amount as a result of liquidation to the respondent would be the practical equivalent of a double deduction, as was held in the *Ilfeld* case.

The liquidating loss of $130,792.11, claimed by the parent in the *Ilfeld* case for the year 1929, was disallowed. This Court disallowed the loss on two grounds: (1) Because it was not permissible under Regulations 75, applicable to 1929 and subsequent years, and (2) because in practical effect it would constitute a second deduction for losses theretofore allowed the parent by the deduction of its subsidiaries' operating losses. With respect to the second ground, the Court said in part (p. 68):

> The allowance claimed would permit petitioner twice to use the subsidiaries' losses for the reduction of its taxable income. By means of the consolidated returns in earlier years it was enabled to deduct them. And now it claims for 1929 deductions for dimi-

> nution of assets resulting from the same losses. If allowed, this would be the practical equivalent of double deduction. In the absence of a provision of the Act definitely requiring it, a purpose so opposed to precedent and equality of treatment of taxpayers will not be attributed to lawmakers. Cf. *Burnet* v. *Aluminum Goods Co.*, 287 U. S. 544, 551. *United States* v. *Ludey*, 274 U. S. 295, 301. * * *

The decision in the *Ilfeld* case, therefore, directly governs this case and shows that the deduction claimed by the taxpayer and allowed by the Circuit Court of Appeals must be denied.

In the very recent case of *United States* v. *Lakewood Engineering Co.*, 70 F. (2d) 887 (C. C. A. 6th), the court not only followed the *Ilfeld* case but extended its principles so as to preclude double deduction of losses even where the stock of the subsidiary was sold at a loss to an outsider. There the taxpayer argued that the cases involving a loss sustained by the parent corporation upon the *liquidation* of a subsidiary, where the operating losses of the subsidiary had been used as deductions in consolidated returns, were not controlling in that here there was a *sale* of the stock of the subsidiary to an *outsider* and that such sale could not be considered an *intercompany* transaction. In answer to this argument the Court pointed out that no such distinction was recognized as important in the *Ilfeld* case. The Court then proceeded to dis-

pose of the case on the broad principles of equitable accounting in the following manner (p. 888):

> Notwithstanding the argument that each of the affiliated corporations is entitled to make the same deduction from net income under the law as it would if it had filed an independent return, and that the subsidiary having suffered an operating loss, and the parent corporation a loss in its investment in the stock of the subsidiary, each is entitled to deduct the full amount of such loss, and that the losses are in no way related, it is difficult to escape the conclusion that the deductions are duplicated. It is true that, if one company standing alone loses upon its investment, it is entitled to deduct its loss. It is equally true that, if the other, standing alone, has an operating loss, it returns no income, but its net loss is of no benefit to anyone as a deduction for the taxable year. The consolidation of returns, however, permits the employment of the subsidiary's loss as a deduction from the net income of the group for the taxable year in which the loss is sustained (*Woolford Realty Co.* v. *Rose, Commissioner,* 286 U. S. 319), and so accrues to the benefit of the parent company in its computation of tax liability. The taxpayer here, however, computes its cost of the stock in the subsidiary by adding to the original purchase price the advances made to its affiliate without making any adjustment for the loss already deducted from income due to operations of its subsidiary, of which it has

already had the benefit, and of which in the absence of affiliation it could not have availed itself.

Let us consider the practical question of whether there is in substance a double deduction here under principles of equitable accounting.

Prior to dissolution the Thane Company sold substantially all its operating assets; these sales were reported in the consolidated return and were included properly in its computation of consolidated net income. The losses sustained thereby were deducted in such consolidated return. The mere act of winding up the subsidiary and dissolving it with the transfer of remaining assets certainly did not give rise to a deductible loss from the viewpoint of the consolidation; that loss had already been suffered over a period of years and was already reflected in the consolidated returns. There was no act or occurrence which was not entirely within the control and power of the parent company; no outside group was affected; it was the mere dissolving of the form of an intercompany relation, which act of itself brought nothing into the affiliated group and saw nothing go out of the group.

Advances made by a parent corporation to its subsidiaries are in their very nature intercompany transactions representing the lending of money by one branch of the business to another for operating purposes. In such case the loss of the group as a

whole has not occurred when the obligation to repay the amount became worthless but at some prior time when the money borrowed was lost in operations. Such a loss has already been reflected by way of deduction either against the income of a successful member of the group or against that of the borrower by carrying it forward under the authority of the net loss provisions of the statutes. To allow the loss on liquidation would clearly result in a duplication of deductions.

An example will show the extent to which such an allowance might possibly be taken. Corporations A, B, and C are affiliated. In 1920 A lends $4,000 to B and B lends the same $4,000 to C to cover a current operating loss. The affiliated group takes a deduction for C's operating loss in 1920. In 1921 C becomes insolvent and B charges off the debt as worthless. In 1922 B becomes insolvent and A gets a deduction for a bad debt. Under such circumstances A, having income in excess of its subsidiaries' losses for each of the years, would have benefited three times on account of the one ultimate loss.

Similarly, the investment in the subsidiary by the purchase of its stock would be the subject of duplicate deductions if the deduction were allowed when the subsidary is liquidated. As a result of purchasing the stock the parent acquires the subsidiary and its assets and operates it as a branch. The cost of these assets, gradually dissipated through operations, will have been represented by deductions taken by the affiliated group

in prior years. To allow their deduction again as capital losses or worthless debts would be to distort the income and to permit, rather than to prevent, the avoidance of tax liability.

The rule of law to be applied to such a set of facts, as found in the case at bar, is clearly provided by this Court in the *Ilfeld* case, to the effect that where, through the medium of consolidated returns during prior years, the taxpayer has been enabled to deduct from its income operating losses of a subsidiary, such losses must be offset against the alleged losses resulting from the subsequent liquidation of the subsidiary. The rule is general and deals with totals rather than detailed items. There is no question of fact involved in the instant case. All essential facts are embodied in the agreed statement of facts, which is a part of the record before this Court. It was beside the point for the lower court to say that the Collector of Internal Revenue should establish specific instances of double deductions, and that a mere similarity of totals as between different years does not justify the inference that the deduction is a double one. The lower court's reasons for refusing to follow the principles laid down by this Court are not clearly stated. The conclusion that the Collector failed to establish any specific instance of a double deduction indicates that the lower court misinterpreted the facts of record, while the statement concerning mere similarity of totals indicates that it

has misconstrued the meaning of a double deduction in cases of affiliated corporations.

The allowance of such deduction would open the door to a method whereby an affiliated group, consisting of parent and subsidiaries, can avoid taxes entirely by saddling upon one of the subsidiaries the unprofitable parts of the enterprise, having that subsidiary borrow from the parent company in order to pay its current obligations, the annual deficit being written off as an operating loss and deducted in the consolidated return, and then, after a number of years dissolving the "unprofitable" subsidiary and absorbing its assets and business, thus taking the loss a second time. The following statement from the opinion of Mr. Justice Cardozo in *Woolford Realty Co.* v. *Rose,* 286 U. S. 319, 329–330, may well be applied to the issue in this case:

> Doubt, if there can be any, is not likely to survive a consideration of the mischiefs certain to be engendered by any other ruling. A different ruling would mean that a prosperous corporation could buy the shares of one that had suffered heavy losses and wipe out thereby its own liability for taxes. The mind rebels against the notion that Congress in permitting a consolidated return was willing to foster an opportunity for juggling so facile and so obvious. Submission to such mischiefs would be necessary if the statute were so plain in permitting the deduction as to leave no room for choice between that construction and another. Expediency may

> tip the scales when arguments are nicely balanced. True, of course, it is that in a system of taxation so intricate and vast as ours there are many other loopholes unsuspected by the framers of the statute, many other devices whereby burdens can be lowered. This is no reason, however, for augmenting them needlessly by the addition of another. * * *

The case of *Burnet* v. *Riggs Nat. Bank,* 57 F. (2d) 980 (C. C. A. 4th), clearly supports the petitioner in the instant case. There the court allowed the parent corporation to deduct such portion of the loss sustained on the liquidation of the subsidiary as was not included in the prior consolidated return, but then went on to say (pp. 983–984):

> On the other hand, we are convinced that the Board of Tax Appeals was right in refusing to allow the claim of the Riggs Bank for the entire loss as at the time of the liquidation, because of the fact that a part of this loss had been deducted by the bank in its return for the first part of the year 1922. To allow the entire loss as of June 10, 1922, would have resulted in respondent receiving credit twice for a part of the loss. *David M. Goodrich* v. *Williams H. Edwards,* 255 U. S. 527, 41 S. Ct. 390, 65 L. Ed. 758; *United States* v. *Ludey,* 274 U. S. 295, 47 S. Ct. 608, 71 L. Ed. 1054.
>
> Double credits equally with double taxation are to be avoided where possible in construing laws passed by Congress.

III

DOUBLE DEDUCTION SHOULD NOT BE ALLOWED

The statute never contemplated that losses should be deducted twice, and unless a double deduction is plainly required it should not be allowed. This Court recently stated the above principle in the *Aluminum Goods Co.* case, supra, where it said (p. 551) that—

> equitable principles of accounting applied to the calculation of the net income of the business unit do not permit deduction of the loss twice, * * *.

Being a grant of special privilege, a claimed deduction must come squarely within the statute. Double deductions like double taxation should never be presumed, and should always be avoided unless clearly provided for by the statute. The statute allows the deduction of losses sustained during the taxable year and not compensated for by insurance or *otherwise*. See Section 234, Revenue Act of 1921. In the instant case, the Government contends that the claimed deduction has already been compensated for by the losses returned by the consolidated group. It has been repeatedly held that the taxpayer, in claiming a beneficial exception, must show a clear right. In the case of *Bank of Commerce* v. *Tennessee,* 161 U. S. 134, this Court said (p. 146):

> Taxes being the sole means by which sovereignties can maintain their existence, any claim on the part of any one to be exempt from the full payment of his share of taxes on any portion of his property must on that account be clearly defined and founded upon plain language. There must be no doubt or ambiguity in the language used upon which the claim to the exemption is founded. It has been said that a well-founded doubt is fatal to the claim; no implication will be indulged in for the purpose of construing the language used as giving the claim for exemption, where such claim is not founded upon the plain and clearly expressed intention of the taxing power.

The general rule was laid down in the case of *United States* v. *Dickson,* 15 Pet. 141, where Mr. Justice Story used this language (p. 165):

> we are led to the general rule of law, which has always prevailed, and become consecrated almost as a maxim in the interpretation of statutes, that where the enacting clause is general in its language and objects, and a proviso is afterwards introduced, that proviso is construed strictly, and takes no case out of the enacting clause which does not fall fairly within its terms. In short, a proviso carves special exceptions only out of the enacting clause; and those who set up any such exception, must establish it as being within the words as well as within the reasons thereof.

And finally, in the *Ilfeld Co.* case, *supra,* which we contend is controlling, this Court said that a deduction is not allowable unless a provision in the Act or regulations may fairly be read to authorize it, and concluded that the deduction if allowed (p. 68)—

> would be the practical equivalent of double deduction. In the absence of a provision of the Act definitely requiring it, a purpose so opposed to precedent and equality of treatment of taxpayers will not be attributed to lawmakers. * * *

To allow the deduction claimed in the instant case would not only distort the underlying purpose of the provisions allowing consolidated returns but would also violate the cardinal rule of construction referred to in the preceding paragraph. In viewing the facts of the case at bar, one cannot fail to conclude that there is the practical equivalent of double deduction.

CONCLUSION

The parent corporation, through the medium of consolidated returns for prior years, has received the benefit of deductions from its income on account of losses of the subsidiary exceeding in amount the losses now claimed. The allowance of the deduction now claimed would amount to a double deduction.

We respectfully submit that the decision of the court below is erroneous and should be reversed.

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Special Assistants to the Attorney General.

OCTOBER 1934.

APPENDIX

Revenue Act of 1921, c. 136, 42 Stat. 227, 254, 260:

SEC. 234. (a) That in computing the net income of a corporation subject to the tax imposed by section 230 there shall be allowed as deductions:

* * * * *

(4) Losses sustained during the taxable year and not compensated for by insurance or otherwise; unless, in order to clearly reflect the income, the loss should in the opinion of the Commissioner be accounted for as of a different period. * * *

(5) Debts ascertained to be worthless and charged off within the taxable year (or in the discretion of the Commissioner, a reasonable addition to a reserve for bad debts); and when satisfied that a debt is recoverable only in part, the Commissioner may allow such debt to be charged off in part;

* * * * *

SEC. 240. (a) That corporations which are affiliated within the meaning of this section may, for any taxable year beginning on or after January 1, 1922, make separate returns or, under regulations prescribed by the Commissioner with the approval of the Secretary, make a consolidated return of net income for the purpose of this title, in which case the taxes thereunder shall be computed and determined upon the basis of such return. If return is made on either of such

bases, all returns thereafter made shall be upon the same basis unless permission to change the basis is granted by the Commissioner.

* * * * *

Treasury Regulations 62:

ART. 631. *Affiliated corporations.*—Consolidated returns are based upon the principle of levying the tax according to the true net income and invested capital of a single enterprise, even though the business is operated through more than one corporation. * * *

ART. 636. *Consolidated net income of affiliated corporations.*—Subject to the provisions covering the determination of taxable net income of separate corporations, and subject further to the elimination of intercompany transactions (whether or not resulting in any profit or loss to the separate corporations), the consolidated taxable net income shall be the combined net income of the several corporations consolidated. * * *

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